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Final Risk Based Capital Framework for Sri Lanka

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Following the release of the draft Risk Based Capital (RBC) Framework in 2011 and the subsequent testing and period of consultation, the Insurance Board of Sri Lanka (IBSL) released the final RBC Framework for Sri Lankan insurers in October 2013. The final RBC Framework is scheduled to become effective for regulatory reporting in 2016, replacing the current factor-based solvency regime. From the first quarter of 2014, companies are required to submit results on both regulatory bases.

In this edition of the Asia e-alert, we present a summary of the new RBC Framework.

The new RBC Framework

Asset valuation

- A company's assets are required to be valued using market consistent methods. Broadly:
    - The government debt instruments are valued at the most recent average buying price quoted by primary market dealers.
    - The corporate bonds and other fixed interest instruments are valued at prevailing market price on Colombo Stock Exchange (if traded) and at net realisable value that is derived based on prevailing interest rate scenario and expected cash-flows (if not traded).
    - The ordinary shares of listed companies are valued at market value.
    - The unit trust/mutual funds are valued at managers' buying price.
    - The freehold land and property are valued at the estimated realisable value as determined by a qualified property valuer approved by the Board.

Liability valuation

- A company's liability for long term business is to be calculated as the sum of the Best Estimate Liability (BEL) and a Risk Margin for Adverse Deviation (RMAD).

- The methodology and assumptions that are to be used to calculate the BEL are as follows:
    - A discounted value of future cash flows, or a gross premium valuation (GPV) is to be adopted.
    - Reserves are to be determined net and gross of reinsurance, on a policy-by-policy basis.
    - The RBC Framework allows for a deterministic approach to valuing liabilities, except for contracts that are deemed to be highly exposed to a particular type of risk, for which a simulation approach has been recommended.
    - The cash flows are required to be discounted using a standard quarterly risk-free yield curve, based on Sri Lankan Government bond rates, which will be published by the IBSL.
    - Companies are allowed to use internal models to derive alternative risk-free yield curves, as long as they have prior approval from the IBSL and the models are based on the prevalent Sri Lankan Government bond rates.
    - Non-market assumptions are required to be based on the best estimate of future experience, allowing for correlations between two or more non-market factors.
    - The BEL for participating business is required to be calculated as the maximum of the guaranteed benefits liability and the total benefits liability, where:
        - The guaranteed benefit liability considers only the guaranteed benefits, which are discounted using risk free rates.
        - The total benefit liability considers both guaranteed and non-guaranteed benefits which are discounted using fund based yields of the participating fund.
    - The BEL for investment-linked contracts is required to be determined as the sum of the unit and non-unit liabilities. The non-unit liabilities are calculated by projecting future cashflows including future expenses and future charges, and setting at a level such that future expenses can be met without additional finances or capital support. All non-unit liabilities are discounted at the risk free rates.
    - Reserves are not required to be floored to zero or the surrender value of the contract.
    - For material options and guarantees, which are greater than 5% of the total policy liabilities, a stochastic methodology is to be used to ensure sufficiency of the reserves at the 75% confidence level.

- The RMAD is to be calculated as the difference between the recalculated liabilities under a combined stress scenario and the BEL. The combined stress scenario is determined as described below:
    - For each product group, the liability is recalculated using up and down stresses that have been prescribed by the regulator.
    - The direction of stress that produces a higher liability is selected.
    - The liability is recalculated by stressing all the risk factors simultaneously in the direction selected for each product group.

Risk-based capital requirements (RCR)

- The RCR is calculated based on prescribed charges for various categories of risks. The RCR formula reflects the following:
    - Correlation between the operational risk, liability risk and the sum of credit risk and market risk.
    - Testing that the minimum total capital held by the company will exceed the surrender value payable in excess of the policy liabilities, if all policies were to surrender immediately.

Total available capital (TAC)

- The TAC is defined as the sum of Tier I and Tier II capital of the insurer.
    - Tier I capital is defined as permanent capital that is fully available to cover the losses of the insurer at all times. A list of eligible capital classes is provided in the RBC Framework. In particular, any valuation surplus that has not been allocated between shareholders and policyholders and 50% of future bonuses in respect of participating business are to be included as Tier I capital.
    - Tier II capital is defined as capital that lacks some of the characteristics of the highest quality capital but provides some degree of loss absorbency during on-going operations. A list of eligible capital classes is provided in the RBC Framework, for example, preference shares, subordinated debts, etc.
    - There is a restriction that Tier II capital should not exceed 50% of Tier I capital.
    - A number of deductions are required to be made from Tier I and Tier II capital for items such as goodwill and deferred income tax assets.

- Admissible assets are to be determined in accordance with the existing Solvency Margin (Long Term Insurance) Rules, 2002, and subsequent notifications. The RBC Framework specifies certain departures from these norms for calculating admissible assets for solvency purposes.

Minimum capital requirements

- The minimum capital requirements have been set as follows:
    - The minimum paid-up capital requirement for long term business is set at LRK500 million.
    - In addition, the TAC is required to exceed the absolute Minimum Capital Requirement (MCR) of LRK500 million.
    - The Capital Adequacy Ratio (CAR), defined as the ratio of the TAC and RCR, should exceed the Required Capital Adequacy Ratio (RCAR) of 120%.
- Any breach of these limits will trigger supervisory action.

Next steps

Although some of the larger insurance companies in Sri Lanka have participated in the testing process before IBSL published the final standard, many other insurers are yet to commence work to adopt the new RBC Framework.

Companies may need to consider the following practical issues in order to be able to implement the new guidelines:

- How to carry out analysis of the historical operating experience in a granular manner. In particular, carrying out a detailed expense analysis by significant product lines, distribution channels and nature of expense (i.e., acquisition and maintenance), and by the drivers of expenses such as ‘per policy’, ‘per premium’, etc., and a detailed lapse experience analysis (by duration, significant product lines and distribution channels, etc.) may be required.
- Whether to invest in actuarial software and staff capable of performing detailed cash-flow modelling.
- How to convert the existing Net Premium Valuation (NPV) calculation methodology to the GPV methodology.
- How to split the accounts/financial statements/shareholders’ funds between life insurance business and non-life business as the RBC requirements applicable to these segments are different.
- How to split the policyholders’ funds into participating and non-participating business segments.
- How to develop appropriate level of documentation for different aspects of management of participating business, including the company’s bonus management framework, policyholders’ reasonable expectations (PRE) in respect of future bonuses, smoothing policy, etc.
- Most importantly, how to invest into capacity building of internal skillsets, especially in the actuarial function.

Strategically, it will also be important for senior management and Boards to understand the implications of RBC insofar as it impacts the investment policy, capital management, pricing and profitability.

The features of the new framework have some of the characteristics of the RBC frameworks that have been introduced relatively recently into Singapore, Malaysia and Thailand, and hence it may be worthwhile and instructive learning more about how companies in these markets and the industry have reacted to such changes.

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